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Geiger, H.M.

Financial readjustments

[Canton]

[c1915]

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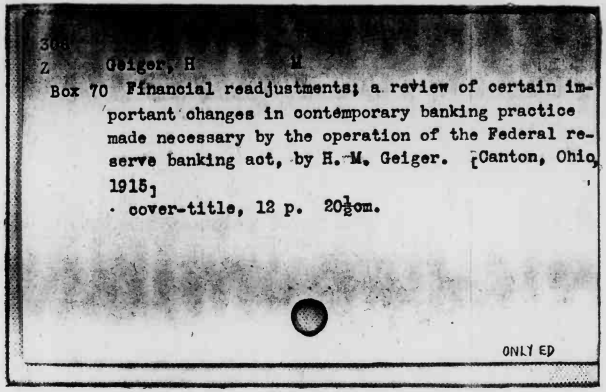
Z Geiger, H M
Box 70 Financial readjustments; a review of certain important changes in contemporary banking practice made necessary by the operation of the Federal reserve banking act, by H. M. Geiger. [Canton, Ohio, 1915]
cover-title, 12 p. 20½cm.
ONLY ED

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TECHNICAL MICROFORM DATA

FILM SIZE: 35mm REDUCTION RATIO: 11:1 IMAGE PLACEMENT: IA (IIA) IB IIB

DATE FILMED: 2-12-97 INITIALS: RB

TRACKING # : MSH 21652

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FINANCIAL READJUSTMENTS

A REVIEW OF CERTAIN IMPORTANT CHANGES IN CONTEMPORARY BANKING PRACTICE MADE NECESSARY BY THE OPERATION OF THE FEDERAL RESERVE BANKING ACT

BY
H·M·GEIGER

Reprinted by the Publishers of
INVESTMENT AND INDUSTRY
Canton, Ohio

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17 March, 1920 - C.R.W.

THERE are several phases of the new Federal Reserve Banking system and the effect it will have upon the manufacturer, the bank depositor and the investor, that have not yet received adequate attention at the hands of those who have been speaking and writing on the subject for several years.

While it is true that the interests of these three classes have been uppermost in my mind during the preparation of my views on the subject, it would be wrong to assume that the same conclusions do not apply with equal force to other classes. Better financing in every department of business is the need of the hour,—and it means just as much to the farmer, the fruit grower or the professional man to get his finances on a proper basis as it does to the manufacturer, the merchant, the banker or the investor. It makes for economy and stability in the end, and tends toward the complete elimination of those unstable elements which have been the cause of a large percentage of all business disasters in the past.

To my mind, one fact about the new banks stands out above all others. It is that, after thirty days of actual operation, during a period of tight money, the new banks had made practically no loans, issued practically no currency, and had found it necessary to make special concessions in the rate of discount, in order to bring out strictly commercial paper that would be paid within thirty days after the discounting transaction.

In other words, though American business needs money, the reported facts about the operation of the Reserve banks would seem to indicate that what business needed was not commercial funds, but more or less permanent capital. During most times in the year, the demand for strictly temporary loans, the proceeds of which are to be used for the purchase of raw material, the payment of wages and the carrying of finished products in warehouse or in transit, is comparatively light.

Permanent Capital is Needed

Even during periods of extraordinary stress, such as the early fall when the crops are being harvested and moved to market, there would be plenty of liquid, commercial capital if it were not for the fact that the demand for permanent, investment capital in America is so intense and insistent at all times that, as soon as a lull in commercial activity releases a small fund, it rushes into investments instead of being temporarily retired or used for other commercial purposes.

As a feature in the economic growth of a lusty young nation, this condition is neither unusual nor unfavorable. We have all been too busy to keep books accurately on a big scale. Consequently no one can tell us exactly what proportion of our assets represent permanent investment; what percentage we use for development and construction; or what sum is absolutely necessary to carry on the rapid-fire exchanges of industry and commerce.

Roughly, we know that certain sums are deposited in savings banks, trust companies and in the savings departments or time certificates-of-deposit of national banks. With some degree of approximation we can guess that these funds are available for more or less permanent investment in stocks, bonds, investment notes or other securities which will not be paid in full until a long period of time has elapsed. But we have no exact account of our "commercial" and our "investment" funds in general.

An Extraordinary Growth

Even without this information, however, the daily practice of business constitutes sufficient proof in itself, that the combined total of all "investment funds" as represented by the resources of savings, trust and insurance companies, private investors and investment banks, are not sufficient to meet the demands created by our industrial expansion. The extraordinary expansion of civilization in America during the past century, has made use of every penny of available capital, has borrowed five or six billions

from Europe, and has still been driven to make merciless inroads on what we should have been taught to respect as our "commercial" fund. This is not a cause for sorrow or of worry. The money has been well used. Our fathers found a wilderness. Since then, the wilderness has not only been reduced to a fairly well cultivated area of farms, cities, mines and factories, but the nation as a whole has kept pace with the unprecedented commercial and industrial progress of the older civilizations of Europe, which had all the fundamentals of their culture built and paid for when we were surveying roads through forests, and following Indian trails across the Western plains.

Our one error was in mistaking the proper functions of our commercial banks. Originally this was a legislative error, recognized as such, and blamed at the time upon the exigencies of warfare. National banks were created to be custodians of the nation's temporary wealth. They were pledged to pay the total sum of their deposits "on demand." They were supposed to loan these deposits on notes having only a short period to run and which would be paid off at maturity. But the government required them to invest the entire sum of their capital in federal bonds having maturities many years distant from the date of sale. To emphasize this essential misconception of sound finance, the bonds thus purchased were made the basis of our national currency. It would be impossible to conceive of any principle that could absolutely guarantee a more rigid, unyielding and burdensome currency than was brought into being by this act of Congress in 1861.

Welcome Relief

Nevertheless the security behind the currency was above question, and the relief of having dollar bills that were worth a dollar, after a long period of wildcat currency, was so welcome to the public that the new national banks became enormously popular.

They found their deposits swelling with unexpected rapidity. The people were so relieved to find a safe, reliable custodian for their funds that they were willing

to go without interest. Thus, the national banks found themselves in possession, in the aggregate, of enormous funds which, in reality, represented savings too great to be used entirely for temporary purposes; yet which the banks were legally required to pay "on demand."

Clearly this was, and is to this day, an abnormal condition. It would be all very well if the demand for temporary capital in the United States were sufficient to make use of all these funds; but there is no such demand because a great part of national bank deposits are not strictly temporary deposits but represent a surplus which, if it is to be used at all, must find employment for other than merely temporary uses. This condition was predicted by a few students when the new law was under discussion. Now it seems to have been demonstrated by events.

Commercial Paper is Scarce

Before the new system had been in operation thirty days it had become clear that very little paper would be offered for rediscount, and it is fair to presume that only a very little paper was in existence that would meet the requirements of the act;—namely, that it be of short maturity and the proceeds used for strictly temporary purposes.

Stated bluntly, it means that a majority of the resources of national banks are tied up in loans of a more or less permanent character. Truly, the notes are usually made for periods of four or six months, but it is the understanding between the banker and the borrower in many instances that these notes shall be renewed indefinitely, provided certain periodical reductions are made and the interest discounted in advance. Moreover, the country is filled with manufacturers who expect bankers not only to finance their temporary needs, but who have also built their plants on capital borrowed and re-borrowed, again and again, from banks.

This practice has been one of the most prolific causes of industrial failures in the United States. Dun's and Bradstreet's reports for many years show that 90 per cent of all failures are due to lack of capital. In very many

instances, excellent enterprises were undertaken at periods when it was easy to secure loans from banks, only to fail in the midst of their development because some contingency forced the bank to withdraw its support and demand the payment of its loans.

So, while the practice of loaning "demand" deposits to borrowers who are not prepared to pay except at the end of a long period, has caused many sleepless nights for bankers, it has also produced innumerable, tragic failures for enterprising men who have seen their plans shrivel up and disappear under the sheriff's hammer, to satisfy a note that had been "called."

Two Funds of Money

That the new banking system will tend to correct these admitted evils is generally conceded. But it seems fair to conclude that no great progress will be made until a proper manipulation of the discount rate has demonstrated some fairly exact figure that can be taken to represent the highest and lowest point in the annual demand for commercial funds. When this figure has been ascertained, it will be fairly safe to conclude that the remaining funds in the custody of the Federal Reserve and National banks are available for permanent investment.

The manipulation of the discount rate in order to ascertain the commercial needs of the country will involve an unprecedented condition in the financial market. In order to coax out commercial paper for rediscount, the Federal Banks will be forced to discount it for rates low enough to make the transaction profitable for the member banks. On the other hand, in order to prevent banks from trying to make similar profits on paper of an investment character, the banks will have to charge high discount rates for paper of long maturities. By the time this discrimination is transmitted to the borrower through the medium of the banks, it will be magnified to an extent which will produce an era of very low money rates for strictly commercial loans, coupled with an era of very high rates for investment loans.

Better Investments

The tendency in this direction is already clear. If the reader will consult his morning paper he will find that the Reserve Banks are offering to rediscount thirty-day paper for considerably less than sixty-day paper.

In simple terms this means that the few advantages which used to lead manufacturers to take a chance and borrow their permanent capital from banks, have been withdrawn. It will cost just as much to get permanent loans from banks as it would cost to sell permanent securities to permanent investors.

Simple economic considerations, therefore, will drive every class of industry into the investment market. Instead of being a debatable question of financial policy, it will become increasingly clear every day, that the best interests not only of industrial establishments themselves, but of the banks and country as a whole, will be best served if those who need permanent capital secure the same by marketing good securities to the public.

Naturally, it will be impossible, suddenly, to reverse our existing practice in this respect. For a long time to come it will be necessary for growing institutions to borrow from banks, and for banks, in a sense, to enter business as silent partners of good enterprises,—but from this time on it should become increasingly easy to put the permanent financing of business on a sound basis, independent of temporary bank loans.

Preferred Stock Is Preferred

The evolution of the industrial preferred stock has proceeded to a point where it is already very popular with an increasingly large and powerful contingent of the investing class. These stocks offer a practical instrument of finance to the manufacturer. In those instances where the contracts have been written and the underwriting made by reliable houses of long experience, preferred stocks, from the investor's standpoint, are amply secured by actual physical property. In the final analysis, they are quite as

substantial as most bonds, and in addition have the advantage of paying tax-free returns of from 6 to 7 per cent.

As legally authorized by various state legislatures many years ago, the issue of preferred stock was a suitable method of financing good industries, but the securities were not made sufficiently attractive to investors. Except for the fact that they had a few privileges and safeguards, they were not calculated to tempt the investor away from the issues listed on various stock exchanges.

At that time, a preferred stock was guaranteed only the privilege of having its dividends paid before any of the earnings could be applied to dividends on the common stock. In event of liquidation, the preferred stockholders were to be paid off before the common stockholders got anything. But, owing to the fact that the business conscience of that day countenanced the practice of stock watering, the preferred stock usually represented the amount actually invested in the property, while the common represented, chiefly, somebody's hopes of unusual profits.

Dollar for Dollar

At the beginning, therefore, the preferred stock of a corporation usually represented a dollar of investment for each dollar of preferred stock. On this basis preferred stocks were not preferred investments. Except for certain features of guaranteeing dividends under favorable circumstances, preferred stocks under the old regime were on about the same basis as good common stocks today. Business conscience has altered in the last ten years. It is now considered dishonest to issue stock which does not represent actual values.

A few individuals, of whom it has been my pleasure to be one, have assisted materially in this development until, today, preferred stocks have been placed on a plane that makes them more desirable in many respects than bonds. Additional safeguards made these stocks very tempting to the public. Many years ago the principle was established that the best preferred stocks were those issued

by going concerns. New enterprises have a few advantages, but unless constructed in a harmony of interest with existing enterprises that are already successful, they are a gamble. The natural growth of the country, however, brings thousands of enterprises every year to the point where they need additional capital to extend their business into new fields or to provide additional plant and equipment to take care of increased demands.

Additional Strength

The success of these growing enterprises is established. Their market is provided. They have strong resources in the form of cash, accounts, inventory and real property. In appraising their net worth it was found desirable not to permit them to count intangible assets, such as good will or patents. Thus, a concern having $1,000,000 of tangible property, might need from $500,000 to $1,000,000 for extensions. If $500,000 of preferred stock were sold and the proceeds invested in the institution, dollar for dollar, the concern would then have $1,500,000 of actual, tangible property. This would be at the ratio of $3 of security to every $1 of preferred stock.

On this basis, preferred stocks became peculiarly attractive to all who were forced to demand good security and at the same time to seek high rates, in order to build up an income adequate to their needs. When further protective features were added, the stocks grew even more popular, and received the approval of many probate judges as investments for trust funds and other quasi-public monies. These latter safeguards consisted in part of requiring that the parent institution must maintain a fund sufficient to pay the preferred dividends for two years in advance.

More popularity accrued to the new preferred stocks when it was realized that their fundamental improvement had been even more marked in another direction. When the preferred had represented investment and the common meant water, the plant produced had only the capacity that could be created by the investment in the preferred

stock. Under the new idea, the plant created is exactly three times the capacity of what could have been created by the preferred alone.

In other words, instead of depending on a plant, which, in favorable times, could easily earn 10 per cent on the preferred issue to pay the dividends, the highly evolved preferred stocks that are available today, have behind them a plant capable of earning 30 per cent or more on the preferred issue. Such a plant might reasonably be expected to earn a 7 per cent preferred dividend during the worst times.

Stronger Common Stocks

Naturally, in erecting such safeguards about preferred issues and making preferred dividends a fixed charge against the business, it was necessary to provide additional advantages for the common stockholders. This was done by guaranteeing that the real management of the business should lodge in their hands. Also, they retained for themselves the exclusive privilege of making big profits from the business.

Throughout the territory with which I am familiar, one of the most remarkable developments within my experience has been the growth of a real understanding of investments by people who had always been too timid to withdraw their funds from banks and make investments on their own responsibility. Throughout this country it has come to be recognized that a preferred stock is a highly seasoned and heavily safeguarded security. For that reason it may be expected, reasonably, to pay a certain fixed return, perpetually, on the investment. It can not be expected to pay more or less than that amount. To pay less would be unfair and unjust to the purchasers of the preferred stock. To pay more, under the practice recently advocated by certain irresponsible writers, would be unfair, not only to the common stockholders who took all the risk, but it would be distinctly unfair to the institution itself.

Partners in the Business

As a corollary to this proposition, investors have been taught that the common share-holders are, in every respect, partners in the business. Their interest is to build up the plant, the organization, the market and every element which may be expected to pay increased profits. Able men have been educating them for years that, so long as the business can be benefited by holding back the earnings and investing them in things which will result in increased earning power, this will be done even though they are forced temporarily to wait for some return on their invested funds. It has been necessary, while doing this, to counsel everyone to whom a steady and assured income was essential, to buy preferred stock, and under no circumstances to purchase common. On the other hand, when steady income was not a necessity and the investor wished to take his chances on getting higher profits later, it has sometimes proved feasible to market limited amounts of common stock to the public.

Thus, there is today a clear understanding of the difference between common and preferred shares. Common stock is now very rarely sold under any misapprehension as to its real character.

Steady Demand for Stocks

Consequently, an enormous, steady market for sound industrial investments has been created through the efforts of a few individuals who began, years ago, to pioneer the field of preferred stocks. These individuals have been assisted by the processes of natural evolution, but whatever the most potent causes have been, the effect is that there exists today adequate machinery for the correction of those financial practices which must be radically modified before a strictly "commercial" banking system can be called successful.

Manufacturers who find the banks charging high rates for loans of long maturity will turn naturally to the field of permanent investment for relief. Some will resort to

mortgages or bonds, either of which will impair their credit; but for the most part the better institutions will take advantage of a market already created, and will sell sound issues of preferred stocks.

Profits for the Banker

This will redound to the benefit of the banker, the borrower and the general financial situation. In the long run it will probably have a tendency to decrease the amount of "demand" deposits in National Banks and to increase the amount of "savings" deposits and individual investments throughout the country. Banks, however, will profit by the increased prosperity of their depositors and borrowers; and by the increase of national wealth which is bound to occur.

As for the investor, it should be a period of splendid opportunities for him. It seems probable that our people will soon surpass the thrifty peasants of France, who, almost without exception, are owners of good securities. In order to market the enormous quantities of stock that will be seeking buyers during the period that is just ahead, a widespread campaign of education will be necessary. Investors will come to know the relative advantages offered by every class of security. Particularly will they be taught the relationship that exists between highly safeguarded preferred stock with its inflexible rate of return, and the more speculative common stock which has no limit to the flexibility either of its price or its dividends.

A Nation of Investors

This campaign of education will lead hundreds of thousands of people to withdraw funds from banks, where they received only 2 or 3 per cent, and re-invest them where they will pay 6 or 7. While this might seem unfavorable to the banks, it is quite the contrary. People prefer to invest in institutions in their own state or city, and the funds they withdraw from banks will, in most instances, be immediately placed in circulation in the same locality and will return to the banks again and again.

There is no phase of this development which will not make for increased prosperity and stability in every class of society. As pointed out in the first instance, it is not going to be easy. A degree of discomfort will be involved in the process, particularly for those who stand at the head of our new financial system. They must devise ways and means to encourage movements which tend to untangle the bookkeeping of the nation. To this extent their work is just as much to encourage sound policies of investment as to foster sound requirements in the commercial field.

If it is well done, we will soon be emancipated from the anomaly of banks that are pledged to pay "on demand," enormous funds which they are forced frankly to loan for long periods. In practice, the volume of "demand" or "commercial" deposits, should approximately equal the volume of "short time" or "commercial loans." This is true for two reasons. In the first place, a "temporary loan" creates a "demand" deposit of equal size the minute the proceeds are placed at the disposal of the borrower. In the second place, the aggregate "temporary" or "working capital" deposits maintained at the banks by individuals and firms has been found not only to offset the borrowings of the same institutions at other times of the year;—but also to offset, with a fair degree of accuracy, the borrowings of *other* institutions at the same time of year.

There is nothing rigid about such a law. It is capable of almost unlimited elasticity, especially with the assistance of the machinery afforded by the new Federal Banks.

When the new banks have enforced strict scrutiny against all loans and have determined what percentage are actually and strictly "commercial" in character, it will be safe to conclude that the surplus of national bank deposits which then exists, does not truly represent the "working capital" of the depositors. Hence, it must represent a more or less permanent surplus to the credit of the depositor, and, in justice to all concerned, should be invested for more or less permanent uses. With this principle ascertained and recognized, this proportion of deposits should not be regarded as "demand" deposits. Eventually it may prove advisable to draw finer distinctions between such deposits and the conventional "commercial" and "savings" departments with which we are all familiar. It may be necessary to create an intermediary class of bank deposits, so that (merely to illustrate) the legal requirement for payment would be: "commercial" deposits, payable on demand; "intermediate" deposits may require 30 days' notice of withdrawal; savings may require 90 days' notice; trust funds, indeterminate. If such a classification were made it would be clear to every good banker how the proceeds of each fund should be invested.

Clearly, the new banking system is meant to perfect the organization and efficiency of the first named "commercial" fund;—but in my opinion it will be impossible to bring this work to a successful culmination until the exact size, character and periodical fluctuation of this commercial fund has been ascertained. If this is true, it should not be unreasonable to hope that an equally accurate inventory of the various classes of "investment funds" can be deduced from the same array of figures. Such a result would tend powerfully to increase the stability of every department of American finance.

NOTE: The author of this article, Mr. H. M. Geiger, is President of The Geiger-Jones Co., Investment Bankers, of Canton, Ohio, and a member of the Investment Bankers Association.

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